Q3 2021 Economic Recap, The Infrastructure Bill, and Proposed Tax Hikes

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We are glad to provide the following economic recap with associated segments on market volatility, the $1.2 trillion infrastructure bill and proposed tax increases. We hope this stimulates some questions surrounding your own portfolio(s) or answers a few questions you may have. Please do not hesitate to reach out to either of us should you wish to discuss further or would like a second opinion on your portfolio.

With all our best,

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Q3 2021 Economic Recap

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The third quarter of 2021 brought moderate market volatility and mixed returns. The S&P 500 and NASDAQ Composite both closed positive for the quarter, rising 0.23% and 0.93% respectively. The Dow Jones Industrial Average finished down -1.91%. As discussions around interest rate hikes increased, the S&P Financials sector rallied 2.29% for the quarter. Investors purchased shares of big banks and insurance companies which have historically done well in a rising interest rate environment. The Fed has recently lowered growth expectations for the year.

While not tremendous, these projections steered investors away from companies that perform well in an expansive economy and toward more defensive names. This led to the S&P Industrials sector cooling off and finishing behind all others, down -4.55%. Heading into Q4, markets will be faced with continued challenges around proposed fiscal policy, interest rates, and inflation.[1]

Inflation is a paramount concern in the U.S. as prices continuously increased throughout the year. Regular grade gasoline prices climbed 47%, from $2.17 to an average of $3.18 per gallon.[2]

Prices of heavily used commodities all increased substantially, including wheat (+13%), coffee (+51%), sugar (+31%), cotton (+35%), corn (+11%), beef (+9%), and milk (+16%).[3]

CPI for September shows overall food and energy prices are up 5% and 25% respectively over the last 12 months.[4] With this, among other factors, the Fed increased their inflation projection for 2021 by another 25% during the quarter, estimating inflation may reach 4.2% in 2021.[5] Meanwhile, the social security cost of living adjustment (SSA COLA) is estimated to increase 6.2%; the most since 1982. SSA COLA tracks the CPI-W index, a specialized measure of inflation heavily weighted for food, housing, and transportation. Although, per Barron's article dated August 21, 2021, even taking COLA increases into account, SSI has still lost 30% of purchasing power since 2000.[6]

Regardless, the Fed firmly believes this inflation cycle is transitory, and primarily caused by supply chain shock. They also believe inflation should run a bit higher than normal for the time being. The Fed's decision to maintain a higher inflation mandate stems from both the economic recovery and pent-up demand as well as Modern Monetary Theory (MMT). Essentially, as the government prints more money, it will be used to invest in the economy, produce more goods and services, increasing GDP, in which they print more money, and the cycle continues. This is understandably a highly debated monetary policy.

This is inconsistent with recent Fed guidance, as GDP growth was lowered from prior estimates down to 5.9%.[7] Several critics of Modern Monetary Theory explain that when inflation runs too hot for too long, purchasing power decreases along with consumer spending. Since GDP is made of both production and consumption, the two sides clash when determining ideal inflation.

Focus Point: $1.2 Trillion Infrastructure Bill and Proposed Tax Increases

In August of this year, the U.S. Senate passed the proposed $1.2 trillion Bipartisan Infrastructure Investment and Jobs Act, which details $550 billion in additional federal spending over the next 5 years. Ongoing negotiations in the House of Representatives have led this package to currently pend a final vote. A key feature of this bill entails $110 billion in additional spending for roads, bridges, and other major projects that are too large for traditional funding programs.

$65 billion would be invested in broadband internet, allowing Americans to have access nationwide. Additionally, $39 billion is allocated to modernize transit, and improve accessibility for the elderly and people with disabilities. Other areas of focus include spending for zero-emission public transit, passenger and freight rail improvements, mass deployment of electric vehicle charging stations across the country, and distribution of zero-emission electric school buses to combat pollution.[8]

The Bipartisan Infrastructure Investment and Jobs Act does not dedicate a section to taxes, and only outlines additional federal spending. Instead, a plan to increase revenues is expected to come via a separate vote. Currently making its way through congress is the proposed budget reconciliation bill, which calculates $2.07 trillion in additional revenue through both corporate and individual tax increases. In this bill, the top corporate tax rate is projected to reach 26.5%. This increase is expected to lower S&P earnings by 4.6% in 2023 and produce just under $1 trillion in federal revenues over the next 10 years.[9]

Individual income tax increases are also suggested to produce an additional $1 trillion in federal revenues over the next 10 years. The top individual income tax bracket currently starts at $518,000 and is expected to be lowered to $400,000, with the top individual tax rate is proposed to increase from 37% to 39.6%. Additionally, the top long-term capital gains tax rate is suggested to increase from 20% to 25%. A vote for the reconciliation bill is not expected for some time, as negotiations are ongoing.[9]

Advisor Viewpoints

Heading into the end of year two of the unprecedented global pandemic that began in 2020, it seems investors are still asking the same questions. Will we see an economic re-lapse, hyperinflation, or worse yet, stagflation? Will tax rates go up? Will growth stall? When will the supply chain normalize?

As fiduciaries and thoughtful investors of client capital, we debate these topics every day. Heading into Q4, we continue to be cautiously optimistic on financial markets. Interest rates, consumer savings rates, and strong corporate balance sheets continue to be major themes driving markets higher and keeping our optimism in check. Thematically, this has led to an enormous amount of innovation from “old economy” type companies, as well as an acceleration of ongoing trends in “new economy” type companies, which further strengthens our conviction towards a barbell strategic capital approach in client stock portfolios.

Bonds continue to be an area of low conviction for our team. When interest rates rise, bond prices fall, causing negative returns for bond portfolios. While the transition out of a 30-year plus decline in interest rates won't happen overnight, we've continued to diversify the income producing side of client portfolios. Investments in opportunities such as Multi-Family Apartments, Industrial Warehouses, Farmland, and Infrastructure which have historically offered a degree of protection against inflation and rising interest rates. Also known as "Alternative Investments", this asset class provides resilient and growing income streams, with potential capital upside, and a historically better response to inflationary environments.

Citations and Disclaimers

[1]Source: FactSet

[2]Source: Weekly Retail Gasoline and Diesel Prices, U.S. Energy Information Administration, figures are YTD

[3]Source: CNBC Futures and Commodities Markets, figures are YTD

[4]Source: U.S. Bureau of Labor Statistics

[5]Source: Board of Governors of the Federal Reserve System, September 21 – 22, 2021 FOMC Meeting Statement

[6]Source: Barron's, Social Security is in Line for Biggest Percentage Bump for Inflation in 40 Years, August 21, 2021

[7]Source: Board of Governors of the Federal Reserve System, September 21 – 22, 2021 FOMC Meeting Projection Materials

[8]Source: Bipartisan Infrastructure Investment and Jobs Act, Fact Sheet, August 2, 2021

[9]Source: TrendMacro, What You're Not Hearing About the Coming Tax Hikes, September 17, 2021

[9]Source: Ibid.

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